

NEWSLETTER

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“Deficits, MMT and inflation”

Investor sentiment has been undermined by localised lockdown measures (in the UK, Madrid, and some French cities), fears on whether the recovery will continue in Europe, given the relapse in the services sector, the failure to approve a new stimulus plan in the US, and uncertainties surrounding Brexit and the US presidential elections.

But not all the news is bad as the US job market continues to open back up, and the business climate is improving in France and Germany. On the pandemic front, vaccine research is a constant source of hope, and the second Covid-19 wave is coming with far lower hospitalisation and mortality rates than earlier this year. The US elections will be a constant backdrop until early November

Market trends

After five consecutive months of gains, global equities gave back 3.4% in September. The US markets and the tech sector underperformed during the correction (with the S&P 500 down by 3.8% and the Nasdaq by 5.1%). They nonetheless led other markets for the quarter and on the year to date (+5.6% and +25.3%, respectively). Switzerland and Japan finished in positive territory (with the SPI and Nikkei up 0.5% and 0.7%, respectively). Bond yields were mostly unchanged (with the US 10Y down by 2bps), and credit underperformed duration (US IG -0.2% and US HY -1.0% vs. +0.3% for the US 7-10Y segment). The dollar rallied by 1.9% vs. the euro from 1.1944 to 1.1728 after bottoming out in late August. In contrast, gold gave back some of its very strong returns (-4.2% on the month, +24.3% on the year to date). Swiss real estate fared very well, gaining more than 4%. Finally, Swiss real estate fared very well (+4%) thanks to reassuring communications from major players in the industry.

Market performance as of 30 September 2020

STOCKS MARKETS	LEVEL	CHANGE SINCE	CHANGE SINCE
	30.09.2020	31.08.2020	12.31.2019
Index			
MSCI World	2367.3	-3.45%	1.70%
USA			
Dow Jones Ind	27781.7	-2.18%	-0.91%
S&P 500	3363.0	-3.80%	5.57%
Nasdaq Comp	11167.5	-5.10%	25.33%
Europe			
Euro Stoxx 50	3193.6	-2.33%	-13.11%
SPI (Switzerland)	12724.7	0.52%	-0.88%
CAC 40 (France)	4803.4	-2.76%	-18.39%
DAX (Germany)	12760.7	-1.43%	-3.69%
FTSE 100 (UK)	5866.1	-1.54%	-20.24%
Japan + Emerging			
Nikkei 225	23185.1	0.68%	-0.60%
CSI 300 (China)	4587.4	-4.70%	14.01%
MOEX Index (Russia)	2905.8	-1.96%	-1.32%
S&P BSE Sensex (India)	38067.9	-1.42%	-6.79%
Ibovespa (Brazil)	94603.4	-4.80%	-18.20%

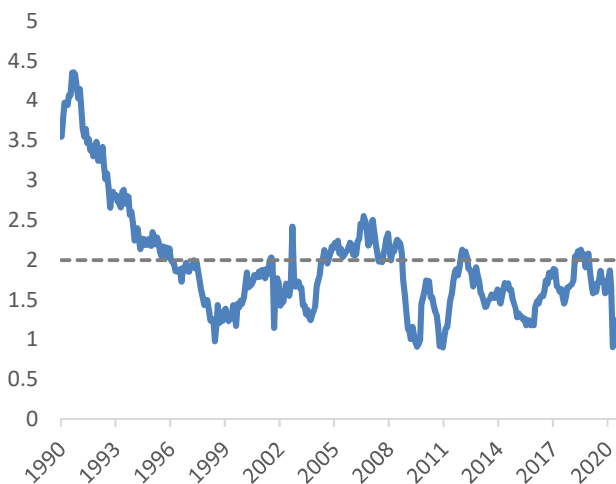
BONDS & ALTERNATIVES MARKETS	LEVEL	CHANGE SINCE	CHANGE SINCE
	30.09.2020	31.08.2020	12.31.2019
Rates			
Germany 10 y	-0.52	-13 Bps	-34 Bps
France 10 y	-0.24	-15 Bps	-36 Bps
Italy 10 y	0.87	-23 Bps	-55 Bps
US 10 y	0.68	-2 Bps	-123 Bps
Debt			
Investment Grade US	334.68	-0.16%	6.20%
Investment Grade Europe	261.04	0.30%	0.78%
High Yield US	2196.37	-1.03%	0.62%
High Yield Europe	398.89	-0.72%	-3.39%
Emerging Debt	885.13	-1.65%	0.37%
Currencies			
EUR/USD	1.17	-1.80%	4.53%
EUR/CHF	1.08	0.07%	-0.57%
USD/CHF	0.92	1.90%	-4.73%
Commodities			
Crude Oil (WTI)	40.22	-5.61%	-34.13%
Gold	1885.82	-4.17%	24.29%

Economic highlights

The Fed gives itself more room to manoeuvre. At the central bankers' meeting in Jackson Hole, the US Federal Reserve made a significant shift in its monetary policy framework, adopting "average inflation targeting" in place of the inflation target in effect since 2012 under Bernanke's leadership. Under this new framework, inflation will be allowed to exceed 2% in order to offset periods during which it was below-target.

Why this change and why now? The change in objective was driven by a long period during which inflation stayed below 2%, even as real equilibrium interest rates fell close to zero, which left very little leeway for easing in the event of future economic contractions.

Personal consumer expenditure (PCE inflation) compared to the Fed inflation target at 2%



Source: Bloomberg, Pâris Bertrand

The reasons for this are structural in nature. Low inflation figures are a common structural problem in major economies. There are many reasons for this: very heavy deflationary pressures brought on by the piling on of debt (interest must be paid and debt paid off, and credit rating downgrades are possible). A second reason is demographic shifts, as lower birth rates tend to squeeze both demand and inflation. Lastly, the broader adoption of technology- and digitalisation-based processes (with enhanced competitiveness and lower production costs) poses an additional challenge to achieving central banks' inflation targets.

This has had a considerable impact on markets. This endemic weakness in inflation has had serious repercussions for the markets, triggering a steep drop in bond yields and an increase in prices of risky assets. The lack of pressure on the prices of goods and services and lower interest rates have, for example, allowed growth stocks to outperform value shares. Lastly, companies can obtain cheap financing

to expand but also to buy back their own shares and/or pay out dividends to their shareholders. Hence, weak inflation and ever more accommodative monetary policies have helped prolong the economic expansion and market gains before the Covid-19 pandemic.

The Fed is not well equipped. Until the early 2000s, low unemployment came with high inflation (this is the empirical relationship shown in the Phillips curve). Since then, the flattening of the Phillips curve has made it especially difficult for the Fed (and the other central banks) to create inflation, even during periods of full employment and despite cuts in key rates and asset-buying programmes.

From a monetary phenomenon, inflation has become "financial". Despite extremely accommodative monetary policies in recent years (with central bank balance sheets expanding on average nine-fold since 2001), inflation has remained muted. The increase in the money supply in circulation, which is used for goods and services transactions, has not encouraged end-consumers to spend more, or companies to invest more in production facilities. However, such policies have inflated asset prices and, from this point of view, have contributed to the wealth effect, which has helped restore confidence, at least partially.

Does the Covid-19 mark a turning point? After the Great Financial Crisis of 2008-2009, the only economic policy interventions were monetary. Remember that fiscal austerity imposed in the euro zone to absorb some of the debt in Mediterranean countries, had exacerbated the deflationary shock. In response to the Covid-19 pandemic, governments and central banks have taken action that is unprecedented in terms of reaction speed, the extent of support, and degree of coordination. This is a sea change, with far more aggressive fiscal policies (in the US, Europe and Asia).

Fiscal policy is taking over. The Federal Reserve has modified its inflation target while fiscal policies have suddenly loosened. As a result, public spending has become an essential tool of economic policy (even in Germany, which initiated the 750 billion euro European recovery plan). Central banks, meanwhile, have been forced to play along by buying public debt in order to keep bond yields very low and under control.

More debt, more deficits, for longer. Assistance to households, companies and local governments has been funded by government bonds, issuance of which are now regarded as necessary to combat the crisis and is tolerated as interest rates are at all-time lows. The US has led the way, having already spent nearly \$3,000 billion (with a federal budget deficit now the equivalent of 15% of GDP) and it may add another 1,000 to 3,500 billion to existing rescue plans if negotiations go through in Congress. Europe is not far behind, with its "Green Pact" and "Next Generation" stimulus plans, which total 1,750 billion euros over a period of 10 years, to rebuild after the pandemic and to support investments in green and digital transitions.

Economic highlights (continued)

Who will pay? Given the crisis's negative and, no doubt, long-lasting impact, governments have no alternative than to issue debt to meet the current and future needs of economic agents. The main concern is whether they can afford such spending. Traditionally, economists maintain that an increase in spending today means that taxes will have to be raised tomorrow. As higher taxes undermines consumer and business spending and as increased borrowing can lead to higher interest rates, some believe that countries cannot afford more spending, even to combat the pandemic-driven recession.

A real-life test for MMT. Modern monetary theory (MMT) is based on the concept that governments are not restricted in how much debt they can take on. In concrete (and simplified) terms, the Treasury Department borrows to fund public deficits, as it usually does, and the Federal Reserve then buys a large portion of this debt (more than 2,000 billion dollars since February 2020). The money thus created can flow into the real economy through the normal channels and boost demand. No need to raise taxes and no interest rate concerns, as the Fed is buying up the Treasury bonds.

What are the risks of things getting out of hand? The main concern about MMT is that the debt issued will finance stimulus plans that will sustain demand and that, at the same time, central banks will increase the amount of money in circulation by buying back this debt. This combination of increased demand and more money is likely to generate a much higher level of inflation in the long run, eroding the purchasing power of money. In the current context, this fear is overdone, as the pandemic's economic shock has not yet been absorbed and has sent inflation to new all-time lows. In the longer term, it is open to question whether these new fiscal policy orientations are likely to encourage inflation after fighting it. Recent history in Japan suggests that it is possible to expand money supply without unleashing inflation (it has stayed very low, averaging less than half a percentage point over the past decade). That said, also keep in mind that runaway inflation often begins with overly expansionist policies. Thus we cannot entirely rule out such a scenario, which could be triggered by ongoing stimulus plans, a weaker dollar, or governments' inability to rein in their spending or raise their taxes.

The message being sent to the markets is that U.S. monetary policy will remain flexible "lower for longer", as the Fed is willing to compensate for lower-than-target inflation by accepting temporarily higher inflation. Moreover, we expect other central banks to follow suit by adapting their inflation target (the European Central Bank is now conducting a strategic review of its monetary policy, with its findings due out in the first half of 2021). The key issue is whether long-term inflation expectations will be better anchored at about 2%. In theory, yes. In practice, we

are reserving judgment for now, given how low inflation has stayed over the past 10 years, despite the strength of the job market.

Investment decisions

The "monetary flood" that has raised fears of currency depreciation is a positive factor for a number of asset classes, such as gold, on which we remain bullish. For its part, the Swiss franc has confirmed its status as a safe haven (since the beginning of the year, the Franc has appreciated against all the major currencies), and we believe that it will remain durably sought after by investors. Finally, and in the context described above, Chinese domestic bonds offer interesting prospects and are the subject of detailed research for investment. For equities, we continue to recommend a diversified regional exposure, including in emerging markets, Europe and Japan, which offer cycle exposure. We continue to prefer quality companies with solid balance sheets and competitive business models.

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